[JOINT COMMITTEE PRINT]

TAX REFORM PROPOSALS: TAXATION OF FINANCIAL INSTITUTIONS

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

SEPTEMBER 12, 1985

J862-46.
S362-30
H782-39

U.S. GOVERNMENT PRINTING OFFICE

51-822 O WASHINGTON : 1985 JCS-38-85

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

CONTENTS

	Page
INTRODUCTION	1
I. OVERVIEW	2
II. SPECIFIC PROVISIONS AND PROPOSALS	5
A. Reserves for Bad Debts	5
1. Commercial banks	5
2. Thrift institutions	20
B. Interest on Debt Used to Carry Tax-Exempt Bonds	30
C. Special Rules for Reorganizations of Financially-Troubled Thrift Institutions	40
D. Credit Unions	43

INTRODUCTION

This pamphlet[1] is prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and the Senate Committee on Finance in connection with the respective committee review of comprehensive tax reform proposals. This pamphlet is one of a series of tax reform proposal pamphlets, and it describes and analyzes tax provisions and proposals relating to the taxation of financial institutions.

The pamphlet describes present-law tax provisions and the tax reform proposal made by President Reagan ("The President's Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration proposal"), the 1984 Treasury Department recommendations to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury report"), Congressional proposals (identified by the primary sponsors), and other related proposals.

The first part of the pamphlet is an overview. The second part discusses specific provisions relating to the taxation of financial institutions, including a description of present law and the changes proposed by the Administration, the 1984 Treasury report, and Congressional members.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Financial Institutions* (JCS-38-85), September 12, 1985.

I. OVERVIEW

Reserves for bad debts

Commercial banks.—Under present law, a commercial bank is permitted a deduction for a reasonable addition to a reserve for bad debts. The reasonable addition to the reserve is defined as the amount necessary to increase the reserve balance to a dollar amount computed under the experience method or the percentage of eligible loan method. Under the experience method, the addition to the reserve is the amount necessary to increase the reserve balance an amount equal to the rate of the taxpayer's average bad debt experience for that year and the previous five years times the loans outstanding at the end of the taxable year. Under the percentage of eligible loan method, the addition to the reserve is the amount necessary to increase the reserve balance to a statutorily set percentage of the outstanding eligible loans as of the end of the taxable year. The current percentage is 0.6 percent. The percentage of eligible loan method is scheduled to expire for taxable years after 1987.

Thrift institutions.—Under present law, a thrift institution (i.e., a building and loan association, mutual savings bank, or cooperative bank) also is permitted a deduction for a reasonable addition to a reserve for bad debts. In addition to either the experience method or the percentage of eligible loan methods, thrift institutions are allowed a deduction equal to 40 percent of the otherwise taxable income so long as a specified percentage of their assets are invested in qualified assets (including home mortgages).

In the case of both commercial banks and thrift institutions, 20 percent of bad debt deductions in excess of those computed using the experience method is disallowed. In addition, banks and thrift institutions are allowed a 10-year net operating loss carryback and a 5 year carryforward (as opposed to the normal rule of a 3-year carryback and a 15-year carryforward).

The Administration proposal would prohibit deductions for additions to a reserve for bad debts for all taxpayers, including commercial banks and thrift institutions, and allow deductions for bad debts as they occur. As a result, the 20-percent disallowance rule of present law for excess bad debt deductions would be repealed. The Administration proposal also would provide commercial banks and thrift institutions with the same net operating loss carryover rules as other taxpayers (i.e., a 3-year carryback and a 15-year carryforward).

Interest on debt used to carry tax-exempt bonds

Present law disallows the deduction of interest payments on indebtedness incurred to purchase or carry tax-exempt obligations. Under a long-standing judicial and administrative interpretation,

financial institution deposits generally are not considered to have been accepted for the purpose of acquiring or holding tax-exempt obligations. Thus, a bank or other financial institution may invest deposited funds in tax-exempt obligations, while continuing to receive a deduction for interest paid to depositors. This contrasts with the treatment of individuals and most non-banking corporations, who are denied an interest deduction to the extent they use borrowed funds to acquire or hold tax-exempts.

The rules regarding corporate preference items (sec. 291), added in 1982, reduce by 20 percent the amount of the otherwise allowable deduction by financial institutions for interest on debt allocable to tax-exempt obligations acquired after 1982. This 20 percent reduction is applied to that portion of the financial institution's interest deduction which is equivalent to the portion of the institution's assets which is invested in tax-exempt obligations. For example, a financial institution that invests 25 percent of its assets in tax-exempt obligations is denied 5 percent (20 percent) of its otherwise allowable interest deduction.

The Administration proposal would deny financial institutions 100 percent of interest deductions that are allocable to tax-exempt obligations acquired on or after January 1, 1986. The amount of interest allocable to tax-exempt obligations would be determined in the same manner as under present law. For example, a financial institution which invests one-third of its assets in tax-exempt obligations would be denied one-third of its otherwise allowable deduction. The present law (i.e., 20 percent) reduction rule would continue to apply with respect to tax-exempt obligations acquired after 1982 and before 1986.

Special rules for reorganizations of financially-troubled thrift institutions

Tax-free reorganization status.—Under present law, in order for a merger or other combination of corporations to be completed on a tax-free basis a significant portion of the shareholders of the combined corporations before the combination must be shareholders after the combination. Present law also provides special rules in the case of financially-troubled thrift institutions under which this test is deemed to be met if substantially all of the depositors of the financially-troubled thrift institution are depositors in the combined corporations after the combination.

The Administration proposal would repeal this special treatment effective after 1990.

Net-operating loss deduction.—Under present law, in order for a successor to a combination of corporations to use the net operating loss deductions of the predecessor corporations, a significant portion of the shareholders of the loss corporations have to be shareholders in the successor corporation. Present law provides a special rule in the case of financially-troubled thrift institutions under which this rule is deemed met if substantially all of the depositors of the loss corporations are depositors of the successor corporation after the combination.

The Administration proposal would repeal this special treatment effective after 1990.

Tax treatment of FSLIC contributions.—Present law provides that contributions by the Federal Savings and Loan Insurance Corporation to financially-troubled building and loan associations or cooperative banks are not includible in income nor do they reduce the basis of any asset.

The Administration proposal would repeal this special treatment for contributions made after 1990, unless made pursuant to a contract to make contributions entered into before 1991.

Credit unions

Under present law, credit unions (including both Federal and State chartered credit unions) are exempt from Federal income tax.

The Administration proposal would repeal the tax exemption for credit unions having assets of $5 million or more, effective for taxable years beginning on or after January 1, 1986. Taxable credit unions would be subject to the same tax rules (including bad debt treatment) as would apply to thrift institutions.

II. SPECIFIC PROPOSALS AND PROVISIONS

A. Reserves for Bad Debts

1. Commercial Banks

Present Law

Under present law, commercial banks[2] are allowed to use either the specific charge-off method or the reserve method in accounting for their bad debts for Federal income tax purposes. Under the reserve method, a bad debt deduction is allowed for the amount necessary to maintain a year-end bad debt reserve balance equal to an amount computed under either the "experience" or the "percentage of eligible loans" methods.[3]

Specific charge-off method

The specific chargeoff method recognizes an expense for bad debts only as they actually become either wholly or partially worthless. All amounts receivable are recorded at their full face value.[4] At such time as a receivable is determined to be uncollectible in whole or in part, the receivable is reduced by the amount of uncollectibility, and an expense is recognized in an equal amount. If an amount previously charged-off as uncollectible is later recovered, the recovery is treated as a separate income item at the time of collection. Wholly worthless amounts are charged-off as a bad debt deduction for Federal income tax purposes in the year in which they become worthless. Partially worthless amounts not only must have become partially worthless for Federal income tax purposes, but must also be charged-off on the taxpayer's books in the amount of such partial worthlessness before a bad debt deduction is allowed for tax purposes.

---

[2] The bad debt provisions discussed herein apply to domestic and foreign corporations, a substantial portion of whose business consists or receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted national banks, and who are subject by law to supervision and examination by State or Federal authority having supervision over banking institutions. Domestic building and loan associations, mutual savings banks or cooperative nonprofit mutual banks are not included in the definition ot commercial bank for this purpose.

[3] Code sec. 585.

[4] Receivables of banks include the principal amount of loans for both cash and accrual method banks. Accrued but unpaid items, including interest and fees, are included in the receivables of accrual method banks, but not in the receivables of cash method banks. Under present law, banks may report for Federal income tax purposes under either the accrual or cash method. However, the Administration proposal would restrict the use of the cash method for larger taxpayers and those currently using methods other than cash for purposes other than tax. See discussion of the cash method in Joint Committee on Taxation, *Tax Reform Proposals: Accounting Issues* (JCS-39-85), September, 1985, Part II. A.

Reserve method

In general.—The reserve method records receivables at their full face value. However, unlike the specific charge-off method, a reserve account is set up as an allowance against the eventuality that some of the receivables may eventually prove to be uncollectible. The actual deduction for bad debts for any year is the amount which is necessary to bring the beginning bad debt reserve, adjusted for actual bad debts and recoveries during the year, to the allowed ending balance computed under one of the approved methods.[5] Thus, amounts specifically charged off or recovered are not items of expense or income per se, but are integral components of the computation of the deductible addition to the reserve.

The results obtained under the reserve method will differ from results obtained under the specific charge-off method if ending reserve balances change from year to year. Where the beginning and ending reserve balances are the same, both methods yield the same net deductible amount. Any increase in the ending reserve balance as compared to the beginning balance will yield a higher deduction under the reserve method, while any decrease will yield a lower deduction. For an ongoing entity, the sum of deductions claimed for all years under the reserve method will exceed the sum of deductions claimed under the specific charge-off method as long as there is a positive bad debt reserve balance in existence at year end.

Experience method.—Under the "experience method," the maximum reserve for bad debts is equal to the amount of outstanding loans which are expected to be uncollectable within the next year. This amount is determined by dividing the total bad debts in the current and five preceding taxable years by the sum of the loans outstanding at the close of each of those years and then multiplying that rate by the amount of outstanding loans. However, the ending reserve balance need not be reduced to an amount less than the balance in the reserve at the close of a statutorially determined base year, so long as total loans outstanding at the close of the current taxable year are at least as great as loans outstanding at the close of the base year. If loans outstanding at the close of the current year are less than loans outstanding at the close of the base year, then the minimum reserve under this alternative is limited to a proportionate part of the base year reserve which bears the same ratio as the ratio of loans at the close of the current year bears to loans at the close of the base year. The base year is the last taxable year before the most recent adoption of the experience method.

Taxpayers may use an averaging period shorter than 6 years with the approval of the Treasury. Treasury has indicated by regulations that a period shorter than 6 years will be appropriate only "where there is a change in the type of a substantial portion of the loans outstanding such that the risk of loss is substantially increased."[6] The computation must be based on actual experience

---

[5] The actual formula is beginning reserve minus actual worthless debts experienced during the year plus actual recoveries during the year plus deductible addition to reserve equals ending reserve. The formula is solved for the deductible addition after all the other amounts are determined.

[6] Treas. Regs. sec. 1.585-2(c)(1)(ii).

during the averaging period. Other evidence indicating a future change in loss experience may not be used except to reduce the averaging period.

Percentage of eligible loans method.—Under the percentage of eligible loans method, the loan loss reserve at the close of the taxable year is equal to a statutorially specified percentage of outstanding eligible loans at the close of the taxable year, plus an amount determined under the experience method for ineligible loans. The specified percentage for tax years beginning after 1982 is 0.6 percent. For tax years beginning after 1975 but before 1982, the specified percentage, was 1.2 percent. For tax years beginning in 1982, the specified percentage was 1.0 percent. Eligible loans for this purpose generally are loans incurred in the course of a bank's normal customer loan activities on which there is more than an insubstantial risk of loss.[7]

As is the case under the experience method, commercial banks utilizing the percentage of eligible loans method are permitted, at a minimum, a balance in the loan loss reserve at the close of the taxable year equal to a base-year level so long as eligible loans have not decreased from their level in the base year. For tax years beginning after 1982, the base year is the last tax year beginning before 1983 (the last year before the rate was dropped to 0.6 percent). If eligible loans have decreased below their base-year level, the minimum bad debt reserve permitted the bank will be reduced proportionately.[8] In addition, the maximum addition for any taxable year to the reserve for losses on loans under the percentage method cannot exceed the greater of either 0.6 percent of eligible loans outstanding at the close of the taxable year or an amount sufficient to increase the reserve for losses on loans to 0.6 percent of eligible loans at such time.

A commercial bank may switch between reserve methods from one year to another. A commercial bank need not adopt a method yielding the largest deduction, although the regulations do prescribe minimum deductions.

Under present law, if the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount which would have been allowed as a deduction on the basis of actual experience, the deduction is reduced by 20 percent of such excess (sec. 291). Also, 59-5/6 percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

The availability of the percentage of eligible loans method is scheduled to expire for taxable years beginning after 1987. For taxable years beginning after 1987, banks will be limited to the experience method in computing additions to bad debt reserves. At that

---

[7] Specifically excluded from the definition of an eligible loan are a loan to a bank; a loan to a domestic branch of a foreign corporation which would be a bank were it not a foreign corporation; a loan secured by a deposit in the lending bank or in another bank if the taxpayer bank has control over the withdrawal of such deposit; a loan to or guaranteed by, the United States, a possession or instrumentality thereof, or to a State or political subdivision thereof; a loan evidenced by a security; a loan of Federal funds; and commercial paper.

[8] There is a further limitation that reduces the bad debt addition under the base year method when the base year loss reserve is less than the the allowable percentage of base year loans.

time, the base year for computation under the experience method will become the last taxable year beginning before 1988.

Determination of worthlessness

The determination of whether a debt is worthless in whole or in part generally is the same for both the computation of deductions under the specific charge-off method and adjustments to the reserve balance made under the reserve method. Worthlessness is a question of fact, to be determined by considering all pertinent evidence, including the value of any collateral securing the obligation and the financial condition of the debtor.[9] A debt is not worthless merely because its collection is in doubt. So long as there is a reasonable expectation that it eventually may be paid, the debt is not to be considered worthless. Wholly worthless debts may be charged off for Federal income tax purposes only in the year they become worthless, and not in some later year when the fact of worthlessness is confirmed. Partially worthless debts must be charged-off on the taxpayer's books in order to be charged-off for Federal income tax purposes. Thus, the charge-off of a partially worthless debt for Federal income tax purposes occurs in the later of the year in which the debt becomes partially worthless or is charged-off on the taxpayer's books. However, the charge-off for Federal income tax purposes cannot occur any later than the year in which the partially worthless debt becomes wholly worthless.

Among the factors which may be considered in determining worthlessness are bankruptcy of the debtor, termination of the debtor's business, the debtor's death or disappearance, receivership of the debtor, and a decline in the value of collateral available to satisfy the debt. None of these factors is in and of itself determinitive, however, and a finding of worthlessness must be predicated on an objective test of all facts and circumstances.[10] Thus, the entering of a debtor into bankruptcy does not by itself establish worthlessness. However, if the surrounding facts and circumstances indicate only a de minimis chance of recovery, a debt may be treated as worthless at that time.[11]

A debt is not worthless merely because it has no current liquidating value if there is a reasonable expectation that it may acquire value in the future. A business debtor may be able to satisfy its obligations out of future activities, despite the fact that it is technically insolvent at the present time. An individual, although currently insolvent, may generate future income that could pay off the debt. Where these expectations are reasonable, the debt is not worthless.

A creditor must normally take all reasonable steps necessary to collect a debt, including legal action if necessary, before it will be held to be worthless. However, where the surrounding circumstances indicate that a debt is worthless and uncollectible and the legal action would in all probability not result in satisfaction, a showing of such facts will suffice, and legal action need not actual-

---

[9] Treas. Regs. sec. 1.166-2(a).

[10] *Denver and Rio Grande Western Railroad Co. v. Comm'r*, 279 F. 2d 368 (10th Cir., 1960).

[11] Rev. Rul. 71-577, 1971-2 C.B. 129. Allowed a charge-off of a wholly worthless bad debt where the receiver in bankruptcy notified creditors that, following liquidation, at most one or two cents on the dollar would be available.

ly be brought.[12] The fact that the debtor refuses to pay or the creditor makes a business decision not to pursue the debtor does not support a charge-off for Federal income tax purposes. The running of any applicable statute of limitations is not conclusive in establishing that a debt has become worthless, unless it is clear that the debtor would avail himself of that defense.[13]

For banks and other financial institutions regulated by Federal or State authorities, worthlessness may be presumed for any debts charged off in obedience to specific orders of such authorities. Also, if the institution has previously charged-off a debt as worthless, and the regulatory authorities confirm in writing that they would have ordered such charge-off if they had audited the institutions books on the date of the charge-off, the presumption will apply.[14]

Background

Legislative history

Since 1921, banks have been allowed to establish reserves for bad debts for Federal income tax purposes. Originally, the bad debt reserve was determined in the same manner as for any other taxpayer.

In 1947, the Internal Revenue Service issued Mimeograph 6209 (1947-2, C.B. 26) which provided that a bank was to be allowed to compute its experience bad debt rate using a 20-year moving average rule. The effect of the mimeograph was to allow consideration of bad debt experience during the Depression in determining the portion of outstanding loans could be expected to become uncollectible and thus includible as a component of the tax reserve. In 1954, the Internal Revenue Service issued Rev. Rul. 54-198 (1954-1, C.B. 60) which provided that an experience type bad debt reserve could be computed using any continuous 20-year period since 1928, or the experience of similar banks for such a period. The effect of Rev. Rul. 54-198 was to allow banks to permanently use their experience during the Depression to compute their bad debt reserves for Federal income tax purposes. At this time, no method comparable to the present percentage of loans method was allowed.

In 1965, the first percentage of loans method was allowed by the Treasury. In Rev. Rul. 65-92 (1965-1, C.B. 112), a uniform reserve ratio equal to 2.4 percent of loans outstanding (other than government-guaranteed loans) was established as a replacement for the special twenty-year period of the earlier rulings. A bank was still allowed to use the experience method, but the experience to be considered was limited to the current and 5 preceding tax years. Special rules were provided which limited the increase to the reserve in any one year and which generally preserved higher reserve levels already in existence using a base year approach similar to present law. In allowing a uniform reserve ratio based on a percentage of loans outstanding, the Internal Revenue Service indicated that it was attempting to address the problem of large variances in the bad debt reserves of various banks for Federal income tax

---

[12] Treas. Regs. sec. 1.166-2(b).
[13] *Suman v. Commissioner*, 26 T.C.M. 420 (1967).
[14] (Treas. Regs. sec. 1.166-2(d).)

Financial and regulatory accounting

The financial accounting of banks must be done in accordance with generally accepted accounting principles (GAAP). For financial accounting purposes, a reserve method would be required in almost all instances. The specific charge-off method would not be allowed. Statement of Financial Accounting Standards No. 5[17] requires that a contingency account be established whenever it is probable that an asset has been impaired and the amount of the loss can be reasonably estimated. As to receivables, FAS 5 provides that, where it is probable that an enterprise will be unable to collect all of its receivables, its receivable asset has been impaired. In cases where the potential amount of loss can be reasonably estimated, the liability for the loss contingency should be recorded currently.

In practice, a financial accountant will generally stratify outstanding receivables into a number of classes based both on the type of receivable (consumer loans, business demand loans, home mortgages, etc.) and on a subjective determination of the risk the receivable will not be repaid. In making the risk determination, such factors as available cash flow and underlying value of the debtor, current value of any collateral securing the receivable, and timeliness of interest payments will be considered. After the stratification is completed, different bad debt rates will be applied to each class in order to establish the reserve for bad debt losses required for that class. The rate used for each class should take into consideration all relevant conditions existing at the date of the balance sheet. These considerations include previous collection experience as well as estimates of the effect of changing business trends and other environmental conditions. "Mechanical forumulas that incorporate only collection experience should not be overemphasized."[18] The ending bad debt reserve for the bank will be the sum of the reserves computed for each separate class.

For financial accounting purposes, the balance in the reserve for bad debts is the expected impairment of the value of a bank's receivables, whenever that impairment will occur. For Federal income tax accounting purposes, the balance in the reserve for bad debts, determined under the experience method, is the expected impairment of the value of a bank's receivables which will occur in the following year. For Federal income tax accounting purposes, the balance in the reserve for bad debts determined under the percentage of eligible loans method is not determined with regard to any expected impairment of the value of a bank's receivables.

Regulatory accounting generally follows financial accounting under generally accepted accounting principles (GAAP) with respect to the recording of bad debt reserves. However, due to the subjective nature of determining the bad debt reserve under GAAP the reserve requirements for regulatory and financial purposes may not always be identical.

---

[17] Hereinafter referred to as ("FAS 5").

[18] American Institute of Certified Public Accountants, *Audits of Banks*, (1983), p. 62.

Administration Proposal

The Administration proposal would repeal the use of both the experience and percentage of eligible loan methods for commercial banks, effective for tax years beginning on or after January 1, 1986. Under the Administration proposal, deductions for bad debts would be allowed when the loans are partially or wholly worthless (i.e., the specific charge-off method would be used). The existing balance in the reserve for bad debts as of the effective date would be included in income (recaptured) ratably over a 10-year period, starting with the first taxable year beginning on or after January 1, 1986. This would place commercial banks on the same footing as other taxpayers. A special alternative would allow commercial banks to elect to include the entire balance in the reserve in income in the first taxable year beginning on or after January 1, 1986.

Other Proposals

1984 Treasury Report

The 1984 Treasury report generally provides for the same treatment as the Administration proposal other than the election to include the existing reserve balance immediately rather than over 10 years.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would repeal the percentage of eligible loans method effective for tax years beginning after December 31, 1986. The experience method would be retained.

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill would repeal the percentage of eligible loans methods effective for tax years beginning after December 31, 1986. The experience method would be retained.

S. 1263 (Roth) and H.R. 2874 (Flippo-Frenzel)

The bill would require that bad debt reserves for tax be conformed to the bad debt reserve maintained for financial statement purposes, up to a maximum bad debt reserve of 1.5 percent of total loans. The greatest tax deduction in any one year would be limited to 0.5 percent of total loans of the taxpayer at the end of that year. Any initial increase in the tax reserve due to the conformity requirement would be spread over 6 years. The changes would apply with respect to taxable years beginning after 1984.

Analysis

Overview

Taxpayers generally are not allowed to deduct future liabilities or expenses until the event giving rise to the liability or expense occurs. In the case of loans, the Federal income tax laws since 1921 have allowed taxpayers to deduct additions to bad debt reserves; that is, to accumulate a bad debt reserve out of pre-tax, rather than after-tax, income. Absent the special provisions for bad debt

reserves, taxpayers would not be allowed to deduct a loan loss until the loan is determined to be wholly or partially worthless. The main issue is whether the reserve method of accounting for bad debts more accurately measures the economic income of lenders than the specific charge-off method that would be required by the Administration proposal. A related issue is the extent to which accrual accounting principles would require a bad debt reserve for lenders that use the accrual method of accounting for Federal income tax purposes. A third issue is the tax treatment of accumulated bad debt reserves on existing loans under the Administration proposal.

Income measurement

Financial and regulatory accounting

Banks that file financial statements with the Securities and Exchange Commission are required to prepare these statements in accordance with generally accepted accounting practice (GAAP). The Office of the Comptroller of the Currency, the Federal Reserve System, and the Federal Deposit Insurance Corporation require banks under their supervision to file quarterly reports ("call reports"). The accounting standards for call reports are set forth by the Federal Financial Institutions Examination Council, and generally conform to GAAP with respect to bad debts.

Under GAAP, a bank must show a bad debt reserve liability (or contra asset) for estimated losses on loans recorded as assets on the bank's books. The bank audit guide issued by the American Institute of Certified Public Accountants sets forth the following standard for the provision of adequate reserves: "The amount of the provision can be considered reasonable when the allowance for loan losses, including the current provision, is considered by management to be adequate to cover estimated losses inherent in the loan portfolio."[19] The reserve is maintained by charges against operating expenses. At the time that a loan is determined to be noncollectible, it is "charged off." The bank's assets are reduced by the amount of the loan principal that is unrecoverable, and bad debt reserves are reduced to the extent of the loss.

Some representatives of the banking industry have argued that the loan loss allowance provided under GAAP should be recognized for Federal income tax purposes. They argue that a bank's allowance for loan losses is subject to review by bank regulators, outside auditors, and other analysts and should be accepted by the Internal Revenue Service. The President's tax reform proposal would allow a bad debt deduction only when a loan is determined to be wholly or partially worthless. In many cases, this would occur when a loss is charged off under GAAP, but could occur later depending on facts and circumstances.

Economic accrual

To correctly measure income, a bad debt deduction should be accrued at the time that the economic loss occurs. For example, suppose that a bank makes 100 loans at the end of year 1, each

[19] American Institute of Certified Public Accountants, *Audits of Banks*, 1983, p. 61.

amounting to one dollar and each maturing in 2 years (i.e., at the end of year 3). Assume that it anticipates that 10 percent of the loans will default each year and it charges sufficiently high interest rates on all 100 loans to make them profitable despite expected defaults. If the bank's loss expectation is accurate, the value of the loan portfolio will decline from $100 to $90 over year 2, from $90 to $81 over year 3, and from $81 to zero at the end of year 3 when $81 of principal is recovered. In this example, $10 of economic loss accrues in year 2 and $9 accrues in year 3. Correct income measurement would require that the $19 bad debt expense be deducted over a two year period as it economically accrues.[20] This would match the deduction of loan losses with the inclusion of interest income which compensates the lender for bearing risk.

If GAAP reserves were respected for Federal income tax purposes, as some commentators have recommended, then a $19 bad debt deduction likely would be allowed in year 1. Under GAAP, it can be argued that this is the amount that is necessary "... to cover estimated losses inherent in the loan portfolio." By contrast, the President's tax reform proposal would not allow a bad debt deduction before loan losses are charged off under GAAP. If loan losses are charged off promptly when they economically accrue, then the Administration proposal would result in a correct measurement of income from lending. However, a bank may not promptly charge off a portion of a loan when its market value drops.[21] In such circumstances, the bad debt deduction under the Administration proposal may be delayed beyond the time when the loss economically accrues.

If bad debts are not promptly charged off at the time loan losses economically accrue, then the specific charge-off method provided in the President's tax reform proposal may overstate economic income and resulting Federal income tax liability. However, modifying the Administration proposal to allow a deduction prior to the time that a bad debt is charged off would allow lenders to deduct bad debts before borrowers are required to include forgiveness of indebtedness income in their taxable incomes. Consistent income measurement would require that the bad debt deduction of the lender be coordinated with the forgiveness of indebtedness income of the borrower.[22]

Comparison of alternative accounting methods

Table 1 compares the measurement of income from a risky loan portfolio under (1) a mark-to-market system (i.e., economic accrual), (2) the experience method in current law, (3) GAAP, and (4) the Administration proposal, assuming that loan losses are charged off (for Federal income tax and books purposes) when they economical-

---

[20] In general, if interest rates are constant over the period, the economic loss arising from default is equal to the fair market value (FMV) of the portfolio at the beginning of the period, plus new loans during the period, minus collections during the period, minus the FMV of the portfolio at the end of the period.

[21] The GAAP standard does not appear to compel a bank to charge off a loan until the chance of recovery is very small. Also, the charge off may be delayed until attempts to structure a work-out arrangement with the borrower completely fail. In addition, banks may be reluctant to promptly charge off defaults because of the adverse effect on reported income.

[22] Where the defaulting borrower is solvent, deferred recognition of forgiveness of indebtedness income results in a potential revenue loss to the Treasury.

ly accrue. As in the example above, it is assumed that a bank makes 100 loans at the end of year 1, each in the amount of one dollar and each maturing in 2 years. The bank anticipates that 10 percent of the loans will default each year and, as a result, it charges a 20 percent interest rate on all 100 loans, instead of 10 percent that would be charged on a riskless loan. The bank's income tax rate is assumed to be 50 percent, and interest and tax rates are constant over the 3-year period.

In this example, the bank earns a 10 percent rate of return on its pre-tax cashflow after loan losses. Nevertheless, under alternative methods of accounting for bad debts, the bank's tax liability and its after-tax cashflow will vary. The impact of alternative accounting methods on the bank's tax liability can be summarized by the effective tax rate. The effective tax rate measures the difference between the pre-tax and after-tax rates of return as a percent of the pre-tax rate of return.

Table 1 shows that if the bank's bad debt deductions were determined under a mark-to-market system, the rate of return on its after-tax cashflow would be 5 percent. Consequently, its effective tax rate would be 50 percent (10 percent minus 5 percent, divided by 10 percent) which is the assumed statutory tax rate. The same effective tax rate would result under the Administration proposal. However, under the experience and GAAP methods of accounting, the bank's effective tax rate would be less than 50 percent. This occurs because bad debt deductions are accelerated relative to the mark-to-mark method of economic accrual. Under the experience method, losses are deducted one year earlier than under the mark-to-market system. Under the GAAP method, loan losses expected to be incurred in future years may be deducted at the time when repayment of the loan is recognized to be in jeopardy.

Table 1.—Cash Flows and Effective Tax Rates Under Various Methods of Accounting for Bad Debts

[Loans charged off promptly]

Item	Year			Total years 1 to 3	Internal rate of return	Effective tax rate [1]
	1	2	3			
Pre-tax Cashflow	−$100.00	$20.00	$99.00	$19.00	10.00%	NA
Loans made	100.00	0	0	100.00		
Collections	0	0	81.00	81.00		
Loss charged off	0	10.00	9.00	19.00		
Loan balance	100.00	90.00	0	NA		
Interest income	0	20.00	18.00	38.00		
After-tax Cashflow Computed Under Alternative Methods						
1. Mark-to-market	−100.00	15.00	94.50	9.50	5.00	50.0%
Interest income	0	20.00	18.00	38.00		
Bad debt deduction	0	10.00	9.00	19.00		
Taxable income	0	10.00	9.00	19.00		
Tax liability	0	5.00	4.50	9.50		
2. Experience method [2]	−95.00	19.50	90.00	9.50	5.26	47.4
Interest income	0	20.00	18.00	38.00		
Reserve balance	10.00	9.00	0	NA		
Bad debt deduction	10.00	9.00	0	19.00		
Taxable income	−10.00	11.00	18.00	19.00		
Tax liability	−5.00	5.50	9.00	9.50		

3. GAAP [3]	−90.50	10.00	90.00	9.50	5.40	46.0
Interest income	0	20.00	18.00	38.00		
Reserve balance	19.00	9.00	9.00	NA		
Bad debt deduction	19.00	0	0	19.00		
Taxable income	−19.00	20.00	18.00	19.00		
Tax liability	−9.50	10.00	9.00	9.50		
4. Administration proposal	−100.00	15.00	94.50	9.50	5.00	50.0
Interest income	0	20.00	18.00	38.00		
Bad debt deduction	0	10.00	9.00	19.00		
Taxable income	0	10.00	9.00	19.00		
Tax liability	0	5.00	4.50	9.50		

[1] The effective tax rate is computed as the difference between the pre-tax and after-tax internal rates of return divided by the pre-tax internal rate of return.

[2] Assumes that similar loans were made in previous years so that the ratio of charge offs in the current and 5 prior years to the loan balance in the current and 5 prior years is 10 percent.

[3] Assumes that losses inherent in portfolio are recognized in the year that loans are made.

In summary, the specific charge-off method of accounting for loan losses, as provided by the Administration proposal, correctly measures economic income if the lender promptly charges off bad debts when economic losses are incurred. In this case, lenders that use the experience method will claim bad debt deductions prior to the time when they economically accrue, and will reduce their effective rate of tax. This favors taxpayers that use the reserve method over taxpayers that use the specific charge-off method. The experience method favors banks with rapidly growing loan portfolios over banks with stable assets (since the tax benefit from accelerating bad debt deductions is larger when these deductions are growing over time).

Accrual vs. cash accounting

Some have criticized the Administration proposal on the ground that accrual method taxpayers in effect would be forced to use the cash method for losses—deducting bad debts only when charged off. It is argued that proper accrual accounting requires a current reserve deduction for losses that are anticipated to occur in order to match the accrual of interest income.[23] In response it can be argued that in a portfolio of loans of similar risk a higher interest rate is charged on all loans to compensate for the percentage of loans that actually default. Interest in excess of the risk-free rate (risk premium) compensates the lender for the possibility of loss. Thus, even though the interest on an individual loan that defaults is accrued prior to the time that the loan is charged off, in a portfolio context, the deduction for charging off a specific loan offsets risk premium income from the solvent portion of the portfolio (see Table 1).

The Administration proposal notes that if a deduction were allowed for additions to GAAP reserves, then an interest charge on reserve balances would be appropriate. This is the method provided in the Administration proposal in the case of property and casualty company loss reserves (i.e., the Qualified Reserve Account method). Under certain circumstances, it can be shown that this method is equivalent in present value to the specific charge-off method.[23a]

Incentive for building reserves

Apart from considerations of proper income measurement, some have argued that recognizing GAAP loan loss allowances for Federal income tax purposes is desirable because it would create a tax incentive for banks to increase their bad debt reserves. Under current law, banks may be reluctant to increase reserves because of the adverse effect on income and net worth as reported for finan-

---

[23] The Administration proposal would not change present law rules governing the accrual of interest income. In some cases, present law requires the accrual of interest due on a loan after the time bank regulators require that the loan be classified as "nonperforming." Some argue that the tax rules for the accrual of interest income should more closely conform to regulatory practices. However, regulatory accounting may be conservative in some cases so that income for regulatory purposes may be less than economic income. The tax accrual of interest income and bad debt deductions are related—the nonaccrual of due but unpaid interest is equivalent to accruing such interest and, simultaneously, charging off a bad debt in the same amount.

[23a] *See*, Thomas Neubig and C. Eugene Steuerle, "The Taxation of Income Flowing Through Financial Institutions: General Framework and Summary of Tax Issues," Dept. of the Treasury, Office of Tax Analysis (September 1983).

cial and regulatory purposes. However, if these reserves were recognized for Federal income tax purposes, tax liability would decrease when reserves were strengthened.

As a matter of tax policy, it is not clear why it is desirable to increase reserves stated in financial and regulatory reports. The accounting standards used in preparing these reports may be conservative, reflecting bank regulators' concerns about ensuring solvency. To the extent that financial and regulatory accounting standards are conservative, book income may be smaller than economic income which, under the Administration proposal, is the proper measure of the tax base.

Administrative issues

Some have argued that an important disadvantage of the bad debt provision in the Administration proposal is that it could result in an increase in disputes between taxpayers and the Internal Revenue Service. Under the Administration proposal, a deduction for a bad debt would be allowed only when the debt is determined to be wholly or partially worthless and charged off the lender's books. It is argued that disputes may arise regarding when a debt is properly charged off. However, the same issue arises under current law. Taxpayers on the reserve method reduce beginning of year reserves by the amount of bad debts charged off. Under the Administration proposal, the determination of when a bad debt may be charged off for Federal income tax purposes would follow the standards in present law. Under the Administration proposal and current law, taxpayers have an incentive to charge off bad debts quickly for Federal income tax purposes (in order to reduce taxable income) and slowly for book purposes (to avoid a reduction in reported income). Thus, under the Administration proposal, the same standards would apply, and the same conflicts would arise, as under present law.

In response to administrative concerns about the President's proposal, it is noted that in 1983 over half of all banks were, in effect, on the specific charge-off method. This occured where a bank's reserve balance remained at its base year level. Many banks using the percentage of eligible loans method had frozen reserves as a result of the decline in the allowable percentage from 1.0 percent, in tax years beginning in 1982, to 0.6 percent in subsequent years. Where the reserve remained level, the bad debt deduction is just equal to the amount charged off for Federal income tax purposes. For banks in this situation, the specific charge-off method produces the same bad debt deduction as present law. For such banks, the administrative burden involved in switching to the specific charge-off method in the President's proposal would not be onerous.

Transition rule

To prevent banks from deducting losses under the new rules on loans for which a bad debt deduction was claimed under current law (thereby obtaining a double deduction), the Administration proposal requires that existing bad debt reserves be recaptured ratably over a 10-year period beginning with the first taxable year starting after 1985.

This transition rule is substantially more generous than simply requiring banks to use current law rules with respect to existing loans. The average ratio of tax reserves to net charge offs for Federal Deposit Insurance Corporation (FDIC) banks is estimated to be less than two in 1983. If this ratio is representative for banks as of the proposed effective date of the Administration proposal, then requiring current law treatment for outstanding loans would effectively recapture these reserves in less than two years. Thus, over a 5-year time horizon, the revenue gain from the 10-year recapture rule would be about one-half that of requiring banks to use current law rules with respect to existing loans.

The Administration proposal includes a provision to tax the windfall gain of taxpayers who claimed accelerated depreciation deductions at present law tax rates and, under the Administration proposal, would be taxed on income from this depreciated property at the proposed lower tax rates. However, the Administration proposal does not tax the windfall gain of taxpayers who claimed bad debt deductions at present law tax rates and would recapture these deductions at the proposed lower tax rates. It can be argued that since bad debt deductions reduced tax liability by 46 cents per dollar (at the 46-percent corporate rate), these deduction should be recaptured at 46 cents rather than 33 cents per dollar (at the proposed 33-percent corporate rate). The windfall gain from the proposed rate reduction could be taxed by increasing the amount of bad debt reserves included ratably in income under the Administration proposal by 39.4 percent (the difference between the current 46-percent tax rate and the proposed 33-percent tax rate, as a percent of the proposed tax rate).

2. Thrift Institutions

Present Law

Under present law, thrift institutions[24] are allowed to use either the specific charge-off method or the reserve method to account for their bad debt expenses for Federal income tax purposes. Where the reserve method is selected, the deduction is allowed for an annual addition to loan loss reserves under the "experience" method, the "percentage of eligible loans" method, or, if a sufficient percentage of the thrift's assets constitute "qualified assets," the "percentage of taxable income" method.

Experience method

The experience method for thrift institutions is identical to the bank experience method discussed above.

Percentage of eligible loans method

The computation for thrift institutions under this method is generally identical to the method for banks discussed above. However, the deduction for any year cannot exceed the amount by which 12 percent of the total deposits or withdrawable accounts of the de-

[24] The term "thrift institutions" is used herein to refer to mutual savings banks, domestic building and loan associations and those cooperative banks without capital stock which are organized and operated for mutual purposes and without profit.

positors of the thrift at the close of the taxable year exceeds the sum of its surplus, undivided profits and reserves at the beginning of such year.

Percentage of taxable income method

Under the percentage of taxable income method, an annual deduction is allowed for a statutory percentage of taxable income.[25] The statutory percentage for tax years beginning after 1978 is 40 percent. The percentage of taxable income deduction amount is added to the reserve in order to determine an ending balance in the reserve.

The full 40 percent of taxable income deduction is available only where 82 percent (72 percent in the case of mutual savings banks without capital stock) of the thrift institution's assets are qualified. Qualifying assets include general cash; obligations and securities of governmental entities including corporations which are instrumentalities of governmental entities; obligations of State corporations organized to insure the deposits of members; loans secured by a deposit or share of a member; loans secured by residential or church real property and residential and church improvement loans; loans secured by property, or for the improvement of property, within an urban renewal area; loans secured by an interest in educational, health or welfare institutions or facilities; property acquired through defaulted loans on residential, church, urban development or charitable property; educational loans; and property used in the business of the association. Where the 82-percent test is not met, the statutory rate is reduced by three-fourths of one percentage point for each one percentage point of such shortfall.[26] For mutual savings banks without capital stock, the statutory rate is reduced by 1-1/2 percentage points for each percentage point that qualified assets fail to reach the 72-percent requirement. At a minimum, 60 percent of a thrift institution's assets must be qualifying (50 percent for mutual savings banks without stock) in order to be eligible for deductions under the percentage of taxable income method at all.

As in the case for the percentage of eligible loans method, the deduction for any year under the percentage of taxable income method cannot exceed the amount by which 12 percent of the total deposits or withdrawable accounts of the depositors of the thrift at the close of the taxable year exceeds the sum of its surplus, undivided profits and reserves at the beginning of such year.

A thrift may switch between methods of determining the addition to its bad debt reserve from one year to another. Such a change does not, however, result in a change in the balance in the bad debt reserve account at the beginning of the year in which the change occurs.

---

[25] Code sec. 593. For purposes of determining the deduction under the percentage of taxable income method, taxable income is computed without regard to any deduction allowable for any addition to the reserve for bad debts and exclusive of 18/46 of any net long-term capital gain, gains on assets the interest on which was tax-exempt, any dividends eligible for the corporate dividends received deduction and any additions to gross income from the thrift's own distributions from previously accumulatd reserves.

[26] For example, consider a thrift institution (other than a mutual savings bank) which has only 75 percent of its assets in qualified assets. The shortfall is 7 percentage points, so the statutory rate is reduced by 5-1/4 percentage points to 34-3/4 percent of taxable income.

Under present law, if the bad debt reserve deduction for the taxable year determined under the above rules exceeds the amount which would have been allowed as a deduction on the basis of actual experience, the deduction is reduced by 20 percent of such excess (sec. 291). Also, 59-5/6 percent of the deductible excess (after the 20-percent reduction) is treated as a tax preference for purposes of computing the corporate minimum tax (sec. 57).

The availability of the percentage of taxable income method is not scheduled for expiration under present law. Thrift institutions will not have the alternative of the percentage of eligible loans method for taxable years beginning after 1987.

A special recapture provision applies to reserve balances in excess of the balance computed under the experience method. When a thrift institution distributes property to its owners, other than as interest or dividends on deposits, in excess of earnings and profits accumulated in taxable years beginning after December 31, 1951, the excess is treated as distributed from the bad reserve account to the extent of the excess of total reserves over experience method reserves. When such a distribution takes place, the thrift institution is required to reduce its reserve by such an amount and simultaneously recognize the amount as an item of gross income. This process increases current year's earnings and profits, and causes such distributions to be taxable to the recipient as dividends in the amount of any excess distributed, rather than as a nontaxable return of capital or as capital gains.

Determination of worthlessness

The determination of worthlessness of a debt under present law is the same as for banks discussed above.

Background

Legislative history

Savings and loan associations, cooperative banks, and mutual savings banks were specifically exempted from Federal income tax prior to 1952 under section 101(2) of the 1939 Code. The Revenue Act of 1951 defined "bank" to include thrift institutions, thereby depriving these organizations of their tax-exempt status. At the same time thrift institutions were deprived of their tax-exempt status, they were allowed to establish a reserve for bad debts up to 100 percent of taxable income to fund this reserve. Consequently, although subject to Federal income tax, thrift institutions paid very little actual tax as a result of the 1951 change.

In the Revenue Act of 1962, Congress established a statutory bad debt deduction for thrift institutions that generally were lower than those permitted under the 1951 Act. A thrift could elect either an annual addition to reserves of 60 percent of its taxable income (subject to a maximum loss reserve of 6 percent of qualifying real property loans) or establish a loss reserve of 3 percent of qualifying real property loans plus a percentge of other loans based on actual experience. Savings and loan associations and cooperative banks could take advantage of these provisions only if 82 percent of their assets were invested in residential real estate, liquid assets, and certain other qualifying assets (qualified assets test). However,

mutual savings banks were not subject to the 82 percent of assets test. The actual experience method was approved as an election for all thrift institutions and a special 5 percent of loans rate was provided for the first $4 million of qualifying loans of new mutual thrift institutions for their first five years of existence.

The Revenue Act of 1962 also established the rule requiring recapture of bad debt reserves in excess of the experience method when distributions to shareholders exceeded current and accumulated earnings and profits. The House Committee on Ways and Means originally reported a more comprehensive recapture provision which would have required recapture of bad debt reserves balances in excess of the balance required under the experience method on distribution to shareholders, whether or not earnings and profits were present. This rule was based on a belief that the special bad debt reserve provisions for thrift institutions were for the protection of depositors and that distributions should not be made to shareholders until full income tax had been paid with respect to the profits so distributed.[27] As passed, however, distributions were treated as coming from the untaxed reserves, and hence subject to recapture, only after earnings and profits had been exhausted (present law).

The Tax Reform Act of 1969 established the basics of the present system. The alternative 3-percent method was eliminated in favor of the experience and percentage of loan methods applicable to banks, and the 60 percent of taxable income deduction was phased down to a 40-percent deduction over 10 years. The qualified assets test was extended to mutual savings banks (at a 72-percent rate). A special provision was added which provided that, where the qualified assets test was not met but at least 60 percent of assets were qualified (50 percent for mutual savings banks), the bad debt deduction would still be available under the percentage of taxable income method, but in a reduced amount.

The Tax Reform Act of 1969 also provided that the excess of the bad debt deduction of a financial institution (including a thrift institution) over the bad debt deduction which would have been allowed under the experience method constitutes an item of tax preference for purposes of the corporate minimum tax.

The Economic Recovery Tax Act of 1981 expanded the definition of organizations eligible for the bad debt rules for thrift institutions to include stock savings banks. The rules applicable to stock savings banks are the same as those applicable to savings and loan associations. The Tax Equity and Fiscal Responsibility Act of 1982 reduced the bad debt deducton of thrift institutions using a method other than the specific charge-off method or the bank experience method by 15 percent of the excess of the deduction otherwise allowable over the deduction which would have been allowable under the experience method. This reduction was part of a boarder cutback in tax preferences. Concurrently, the portion of the actual deduction in excess of the amount allowable under the experience method constituting a tax preference item for purposes of the minimum tax was reduced to 71.6 percent. The Deficit Reduction Act of

[27] H. Rep. No. 1447, 87th Congress, 2d Sess. (1962).

1984 increased the cutback of deduction to 20 percent of the excess of the deduction over that allowable under the experience method and decreased the minimum tax preference inclusion rate to 59-5/6 percent.

Financial accounting methodology

The financial accounting methodology for thrift institutions is the same as for banks.

Regulatory accounting

For regulatory purposes, thrift institutions are no longer required to maintain specific reserves to offset potential bad debt losses. Instead, the Federal Home Loan Bank Board (FHLB) requires that thrift institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) satisfy a minimum net worth requirement designed to guarantee adequate capitalization of the institution.[28] The present net worth requirement consists of the sum of the amounts determined under four separate factors. These are the "base factor" (generally 3 percent of most liabilities), the "growth factor" (a varying percentage determined by the rate of growth in liabilities), the "contingency factor" (including 2 percent of recourse liabilities, 10 percent of the amount of direct investment in non-traditional activities, and 20 percent of "scheduled items")[29] and the amortization factor (a phase-in of the more restrictive application of the net worth rules). For regulatory purposes, net worth consists of all reserve accounts (other than those related to the valuation of a specific asset), retained earnings and all capital stock accounts.[30]

The primary focus of regulatory concern is to insure that adequate capitalization exists within an institution to support the level of activities in which the institution is engaged. The presence of adequate capitalization minimizes the risk of failure which would result in the FSLIC being required to fulfill its obligation to the institution's depositors. This focus is substantially different from the focus of tax accounting (the measurement of net income in a given period) or the principle focus of financial accounting (the measurement of the net value of the assets given potential impairment). For this reason, the amount of the requirement is measured primarily with respect to the amount of the institution's liabilities. Where asset values are considered (such as through the contingency factor), it is to measure a potential dimunition in the asset's value as that dimunition could affect the ability of the institution to meet its obligations. Total capitalization, including reserve accounts, is measured since it is ability to meet obligations that is the concern. Had no reserve accounts been maintained, the equity of the institution would be increased by the amount which would

---

[28] 12 C.F.R. sec. 563.13 (1985). The present regulations became effective on March 21, 1985. Prior to that time, a joint requirement of a reserve for liabilities to depositors in insured accounts and a minimum net worth requirement applied. The change unified the two requirements into a single net worth requirement and expanded the elements which are considered in determining required minimum net worth.

[29] Scheduled items include "slow loans" and foreclosed real estate among other items. 12 C.F.R. sec. 561.15.

[30] 12 C.F.R. sec. 561.13.

exist in the reserves. So long as the minimum amount of net equity is kept, distribution of amounts, which would otherwise not have been available due to their being placed in a reserve, is prevented.

Administration Proposal

The Administration proposal would repeal the use of the experience, percentage of eligible loans and percentage of taxable income methods for thrift institutions effective for tax years beginning on or after January 1, 1986. Under the Administration proposal, deductions for bad debts would be allowed when the loans are partially or wholly worthless (i.e., the specific charge-off method would be used). This results in the same treatment for thrift institutions as for all other taxpayers. That portion of the reserve balance on the effective date which is equal to the greater of the reserve which would be required under the experience or percentage of eligible loans methods will be required to be taken into income ratably over ten years. At the election of the thrift, the portion of the reserve to be included in income can be taken entirely in the first tax year the proposal is effective.

Other Proposals

1984 Treasury Report

Like the Administration proposal, the 1984 Treasury report would repeal the use of the three reserve methods. However, the Treasury proposal would require the inclusion in income over a 10-year period of the entire reserve amount, not just the greater of the reserve amounts computed under the experience or the percentage of eligible loans methods. The alternative to elect immediate inclusion of the reserve amount rather than inclusion over a 10-year period would not be available.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would repeal the percentage of eligible loans method and the percentage of taxable income method effective for tax years beginning after December 31, 1986. The experience method would be retained.

H.R. 2222 and S. 1006 (Kemp-Kasten)

The Kemp-Kasten bill would repeal the percentage of eligible loans method and the percentage of taxable income method effective for tax years beginning after December 31, 1986. The experience method would be retained. (The Kemp-Kasten and Bradley-Gephardt bills are identical with respect to the bad debt reserves of thrift institutions and banks.)

S. 1263 (Roth) and H.R. 2874 (Flippo-Frenzel)

The bill would require that tax bad debt reserves for commercial banks be conformed to the bad debt reserve maintained for financial statement purposes, up to a maximum reserve of 1.5 percent of total loans. The greatest tax deduction in any one year would be limited to 0.5 percent of total loans of the taxpayer at the end of that year. Any initial increase in the tax reserve due to the con-

formity requirement would be spread over 6 years. The changes would apply with respect to taxable years beginning after 1984. The bill would repeal the current experience method and percentage of eligible loans method of computing reserves for bad debts of commercial banks.

Analysis

Overview

Taxpayers generally are not allowed to deduct future liabilities or expenses until the event giving rise to the liability or expense occurs. In the case of loans, the Federal income tax laws have since 1921 have allowed taxpayers to deduct additions to bad debt reserves; that is, to accumulate a bad debt reserve out of pre-tax rather than after-tax, income. Absent the special provisions for bad debt reserves, taxpayers would not be allowed to deduct a loan loss until the loan is determined to be wholly or partially worthless.

Thrift institutions (i.e., mutual savings banks, domestic building and loan associations, savings and loan associations, and cooperative banks without capital stock) are granted more favorable Federal income tax treatment in the computation of their bad debt deductions than banks and other creditors. Thrift institutions are allowed to compute the deductible addition to their bad debt reserves under the percentage of taxable income method in addition to any of the three methods available to commercial banks (i.e., the experience method, the percentage of eligible loans method, and the specific charge-off method).

The bad debt deduction of thrift institutions can be viewed as comprised of two components: (1) the deduction that would be allowable if thrift institutions were subject to the same rules as commercial banks, and (2) the deduction in excess of this amount. The main issue there is whether the reserve method of accounting for bad debts more accurately measures the economic income of lenders than the specific charge-off method that would be required by the Administration proposal. To the extent that the percentage of taxable income method for thrift institutions results in a larger bad debt deduction than the methods available to commercial banks, this can be viewed as a tax incentive for encouraging thrift institutions to specialize in residential mortgage lending and certain other qualified lending. With respect to the component of thrift bad debt deductions intended as an incentive for qualified lending, the main issue is whether or not there should be such an incentive and, if so, whether the incentive is effective. A second issue is the Federal income tax treatment under the Administration's proposal of bad debt reserves accumulated on existing loans.

Incentive component of thrift bad debt reserves

The percentage of taxable income method for thrift institutions was designed at least in part to encourage residential mortgage lending. However, the present system is estimated to cost $1 billion per year in lost Federal tax revenue,[31] and may not be well de-

---

[31] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1986-1990* (JCS-8-85), April 12, 1985.

signed to achieve its objective. Under present law, commercial banks and investors other than thrift institutions (which are excluded from the percentage of taxable income method) are given no tax incentive to engage in residential mortgage lending. Thrift institutions with less than 60 percent of assets invested in residential mortgages and other qualifying assets also have no incentive to increase their mortgage lending, nor do thrift institutions whose qualifying assets exceed 82 percent of total assets (72 percent for mutual savings banks). The 10-point difference in the asset requirements between savings and loan association and mutual savings banks appears to create an uneven playing field for competition between these institutions. Also, to the extent that the present system encourages thrift institutions to specialize in mortgage lending (at least up to the 82- and 72-percent levels), it is inconsistent with regulatory policies that encourage greater diversification of loan portfolios.

The Administration proposal would require banks and thrift institutions to compute their tax in the same manner as other corporations, that is, to use the specific charge-off method for deducting loan losses. The efect of such a change will be to increase the marginal rate of tax for these institutions from 31.4 percent to 33 percent. The present law tax advantage of thrift institutions relative to commercial banks and other corporations would be eliminated, as would the tax incentive for thrift institutions to specialize in residential mortgage lending. If Congress desires to retain a tax incentive for residential mortgage lending, then a generalized tax incentive available to all mortgage lenders could be enacted. However, it should be noted that one of the present law tax preferences retained by the Administration proposal is the deductibility of interest on loans secured by a taxpayer's principle residence. This tax expenditure, estimated to reduce Federal income tax revenues by over $27 billion in fiscal year 1986, provides a substantial incentive for homeownership and residential mortgage lending. The Administration proposal also retains the provisions of present law that defer and exclude a portion of capital gains realized from the sale of a principal residence.

Transition rule

The Administration proposal would allow lenders to deduct loans charged off in taxable years beginning after 1985, even though reserve deductions may have been claimed for these loans in prior tax years. To prevent a double deduction of loan losses, taxpayers other than thrift institutions would be required to include existing bad debt reserves in income over a 10-year period beginning with the first taxable year starting after 1985. In the case of thrift institutions using the percentage of taxable income method, the incentive portion of bad debt reserves would not be recaptured (i.e., included in taxable income). The incentive portion of thrift bad debt reserves would be determined as the excess of existing reserves over the greater of reserves computed using the two alternative reserve methods available to thrift institutions under present law (i.e., the experience and percentage of eligible loan methods). Thus, the transition rule for thrift institutions is more generous than

that for other lenders since a portion of existing reserves may be exempted from current tax.

The non-incentive portion of thrift reserves would be recaptured over 10 years in the same manner as the bad debt reserves of taxpayers other than thrift institutions. Since the amount subject to recapture is limited to the greater of reserves computed under the experience and percentage of eligible loan methods, thrift institutions would have an incentive to rearrange their portfolios in such a manner as to reduce the amount recaptured and, correspondingly, increase the amount forgiven. Where the percentage of eligible loans method results in larger reserves than the experience methods, thrift institutions could reduce the recapture amount by exchanging qualified assets (such as home mortgages) for nonqualified assets (such as Government National Mortgage Association certificates) immediately before the effective date. To prevent this type of manipulation, the Administration proposal could be modified to recapture reserves computed according to the percentage of eligible loans method as of December 31, 1984 (or some other date prior to release of the Administration proposal), if greater than the amount otherwise subject to recapture.

The Administration proposal does not tax the windfall gain of taxpayers who claimed bad debt deductions at present law tax rates and would recapture these deductions at the proposed lower tax rates. It can be argued that since bad debt deductions reduced tax liability by 46 cents per dollar (at the 46-percent corporate rate), these deductions should be recaptured at 46 cents rather than 33 cents per dollar (at the proposed 33-percent corporate rate). The windfall gain from the proposed rate reduction could be taxed by increasing the amount of bad debt reserves included ratably in income under the Administration proposal by 39.4 percent (the difference between the current 46-percent tax rate and the proposed 33-percent tax rate, as a percent of the 33-percent tax rate).

Under present law, distributions to shareholders by domestic building and loan associations and institutions that are treated as mutual savings banks, are subject to a tax benefit rule. Distributions in excess of earnings and profits (accumulated after 1951) are treated as made out of bad debt reserves for qualifying loans in excess of reserves determined using the experience method. In addition, such distributions are included in the gross income of the payor. The effect of this provision is to recapture the tax benefits associated with the percentage of taxable income method of computing bad debt reserves to the extent that an investor-owned thrift institution distributes retained earnings attributable to these tax benefits. Under the Administration proposal, it is unclear whether distributions out of bad debt reserves that are not recaptured would be subject to the tax benefit rule in present law. Since the tax benefit rule was part of present law when investor-owned thrift institutions took advantage of the percentage of taxable income method, it can be argued that an exemption from this rule would constitute retroactive tax relief to investors in these institutions.

Some thrift institutions have followed financial accounting procedures which treat the tax deduction for bad debts under the percentage of income method as a reduction in their effective tax rate

rather than as a timing difference. As a result, no amounts currently exist in their deferred tax reserve accounts to cover the additional tax resulting from the Administration's proposal to recapture a portion of the bad debt reserve. It is likely that all additional tax due to recapture would be required to be reported for financial purposes as an expense in the year the provision becomes effective, irrespective of the fact that it would be paid over a ten-year period. A similar approach would likely be required for regulatory purposes.

A certain level of net worth is required for regulatory purposes. Thus, it is argued that a sudden decrease in net worth as a result of the Administration proposal could result in many thrifts failing to meet regulatory requirements. In response, it is argued that the problem lies not with the Administration's recapture proposal, but rather with the failure of certain thrift institutions to show a deferred tax liability on their balance sheets. Thus, it is argued, the problem is one of a failure to follow adequate accounting procedures in the past, and not a problem of tax policy.

B. Interest on Debt Used to Purchase or Carry Tax-Exempt Obligations

Present Law and Background

In general

Present law (sec. 265(2)) disallows a deduction for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. This rule applies both to individual and corporate taxpayers. The rule also applies to certain cases in which a taxpayer incurs or continues interest expense and a related person acquires or holds tax-exempt obligations (sec. 7701(f)).[32]

Application to taxpayers generally

The Internal Revenue Service and the courts have consistently interpreted section 265(2) to disallow an interest deduction only when a taxpayer incurred or continued indebtedness for the purpose of acquiring or holding tax-exempt obligations.[33] They have employed various tests to determine whether a taxpayer has the prohibited purpose. In general, when a taxpayer has independent business or personal reasons for incurring or continuing debt, the taxpayer has been allowed an interest deduction regardless of his tax-exempt holdings. When no such independent purpose exists, and when there is a sufficiently direct connection between the indebtedness and the acquisition or holding of tax-exempt obligations, a deduction has been disallowed.

In *Wisconsin Cheeseman, Inc. v. United States*, 388 F. 2d 420 (7th Cir. 1968), an interest deduction was disallowed for a corporation which took out short-term bank loans to meet recurrent seasonal needs for funds, pledging tax-exempt securities as collateral. The court held that the taxpayer could not automatically be denied a deduction because it had incurred indebtedness while holding tax-exempt obligations. However, use of the securities as collateral established a sufficiently direct relationship between the loans and the purpose of carrying tax-exempt securities. The court stated further that a deduction should not be allowed if a taxpayer could reasonably have foreseen, at the time of purchasing tax-exempts, that a loan would probably be required to meet ordinary, recurrent economic needs.

---

[32] In addition to interest deductions, present law (sec. 265(1)) denies a deduction for nonbusiness expenses for the production of tax-exempt interest income, which expenses would otherwise be deductible under section 212. This may include, for example, brokerage and other fees associated with a tax-exempt portfolio. Present law also disallows deductions for certain expenses of mutual funds which pay tax-exempt dividends and for interest used to purchase or carry shares in such a fund.

[33] Legislative history indicates that Congress intended the purposes test to apply. *See*, e.g., S. Rep. No. 617, 65th Cong., 3d Sess. 6-7 (1918); S. Rep. No. 398, 68th Cong., 1st Sess. 24 (1924); S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934).

In Rev. Proc. 72-18, 1972-1 C.B. 740, the Internal Revenue Service provided guidelines for application of the disallowance provision to individuals, dealers in tax-exempt obligations, other business enterprises, and banks in certain situations. [34]

Under Rev. Proc. 72-18, a deduction is disallowed only where indebtedness is incurred or continued for the purpose of purchasing or carrying tax-exempt obligations. This purpose may be established either by direct or circumstantial evidence. Direct evidence of a purpose to purchase tax-exempt obligations exists where the proceeds of indebtedness are directly traceable to the purchase of tax-exempt obligations or when such obligations are used as collateral for indebtedness, as in *Wisconsin Cheeseman* above. In the absence of direct evidence, a deduction is disallowed only if the totality of facts and circumstances establishes a sufficiently direct relationship between the borrowing and the investment in tax-exempt obligations. A deduction generally is not disallowed for interest on an indebtedness of a personal nature (e.g., residential mortgages) or indebtedness incurred or continued in connection with the conduct of an active trade or business.

Under Rev. Proc. 72-18, when there is direct evidence of a purpose to purchase or carry tax-exempt obligations, no part of the interest paid or incurred on the indebtedness (or on that portion of the indebtedness directly traceable to the holding of particular tax-exempt obligations) may be deducted. In other cases, an allocable portion of interest is disallowed, to be determined by multiplying the total interest on the indebtedness by the ratio of the average amount during the taxable year of the taxpayer's tax-exempt obligations to the average amount of the taxpayer's total assets.

Rev. Proc. 72-18 provides specifically that dealers in tax-exempt obligations are denied an interest deduction when they incur or continue indebtedness for the purpose of holding tax-exempt obligations, even when such obligations are held for resale.[35] When dealers incur or continue indebtedness for the general purpose of carrying on a brokerage business, which includes the purchase of both taxable and tax-exempt obligations, an allocable portion of interest is disallowed. However, the disallowance rule generally does not apply where indebtedness is incurred to acquire or improve physical facilities. The revenue procedure does not specify under what circumstances, if any, a bank is to be treated as a dealer in tax-exempt obligations.

Application to financial institutions

Allowance of deduction for interest paid on deposits

Legislative history suggests that Congress did not intend the disallowance provision to apply to the indebtedness incurred by a bank or similar financial institution to its depositors.[36] The IRS

---

[34] That is, those situations not covered by Rev. Proc. 70-20, 1970-2 C.B. 499, discussed below.

[35] *See, Leslie v. Comm'r*, 413 F.2d 636 (2d Cir. 1969), *cert. den.* 396 U.S. 1007 (1970). The court in *Leslie* held specifically that the exemption of banks under the disallowance provision did not apply to a brokerage business.

[36] *See* S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934); S. Rep. No. 830, 88th Cong., 2d Sess. 80 (1964).

took the position as early as 1924 that indebtedness to depositors was not incurred to purchase or carry tax-exempt obligations, within the meaning of the law. In Rev. Rul. 61-22, 1961-2 C.B. 58, the IRS restated its position that the provisions of the law "have no application to interest paid on indebtedness represented by deposits in banks engaged in the general banking business since such indebtedness is not considered to be "indebtedness incurred or continued to purchase or carry obligations * * *" within the meaning of section 265."

Despite this general rule, the IRS has attempted to disallow interest deductions of financial institutions in certain cases. Rev. Rul. 67-260, 1967-2 C.B. 132, provided that a deduction will be disallowed when a bank issues certificates of deposit for the specific purposes of acquiring tax-exempt obligations. The ruling concerned a bank which issued certificates of deposit in consideration of, and in exchange for, a State's tax-exempt obligations, the certificates having approximately the same face amount and maturity dates as the State obligations.

In Rev. Proc. 70-20, 1970-2 C.B. 499, the IRS issued guidelines for application of the disallowance provision to banks holding tax-exempt State and local obligations. Rev. Proc. 70-20 provides that a deduction will not be disallowed for interest paid or accrued by banks on indebtedness which they incur in the ordinary course of their day-to-day business, unless there are circumstances demonstrating a direct connection between the borrowing and the tax-exempt investment. The IRS will ordinarily infer that a direct connection does not exist (i.e., a deduction will ordinarily be allowed) in cases involving various forms of short-term indebtedness,[37] including deposits and certificates of deposit; short-term Eurodollar deposits and borrowings; Federal funds transactions and similar interbank borrowing; repurchase agreements; and borrowing directly from the Federal Reserve to meet reserve requirements. Within these categories, unusual facts and circumstances outside of the normal course of business may demonstrate a direct connection between the borrowing and the investment in tax-exempt securities; in these cases, a deduction will be disallowed. However, IRS will not infer a direct connection merely because tax-exempt obligations were held by the bank at the time of its incurring indebtedness in the course of its day-to-day business.

Under Rev. Proc. 70-20, application of the disallowance provision to long-term capital notes is to be resolved in the light of all the facts and circumstances surrounding the issuance of the notes. A deduction is not to be disallowed for interest on indebtedness created by the issuance of capital notes for the purpose of increasing capital to a level consistent with generally accepted banking practice. Types of borrowings not specifically dealt with by the revenue procedure are to be decided on a facts and circumstances basis. Ad-

---

[37] For purposes of the revenue procedure, "short-term bank indebtedness" means indebtedness for a term not to exceed three years. A deposit for a term exceeding three years is treated as short-term when there is no restriction on withdrawal, other than loss of interest.

ditionally, Rev. Proc. 72-18, discussed above, is applicable to financial institutions in situations not dealt with in Rev. Proc. 70-20.[38]

Since the issuance of Rev. Proc. 70-20, several cases and rulings have addressed the issue of bank deposits or similar arrangements which are secured or collateralized by tax-exempt obligations. These decisions have generally refrained from applying the disallowance provision.

Rev. Proc. 78-34, 1978-2 C.B. 535, allowed a deduction for interest paid by commercial banks on borrowings of Treasury tax and loan funds when those borrowings are secured by pledges of tax-exempt obligations. The IRS took the position that this type of borrowing is in the nature of a demand deposit.

In *Investors Diversified Services, Inc. v. United States,* 573 F. 2d 843 (Ct. Cl. 1978), the court found that the use of tax-exempt securities as collateral for face-amount certificates[39] was not sufficient evidence of a purpose to purchase or carry tax-exempt obligations and, therefore, allowed an interest deduction. Noting various similarities between banks and face-amount certificate companies, the court held that the rationale for the "bank exception" to the disallowance provision was equally applicable to these companies. The court cited three further grounds for holding the disallowance provision inapplicable: (1) that the sale of certificates (i.e., borrowing) was wholly separate from and independent of the company's investment process, including the acquisition and maintenance of tax-exempt securities; (2) that the essential nature of the company's business was the borrowing of money which had to be invested in order to pay off the certificate holders; and (3) that the company could not reduce its borrowings by disposing of its tax-exempt securities, since only the certificate holders had the power to terminate each certificate.

Finally, in *New Mexico Bancorporation v. Comm'r.,* 74 T.C. 1342 (1980), the Tax Court permitted a bank a deduction for interest paid on repurchase agreements which were secured by tax-exempt State and municipal obligations. The court concluded that the repurchase agreements were similar to other types of bank deposits, and were not the type of loans or indebtedness intended to be covered by the disallowance provision. Furthermore, the bank's purpose for offering repurchase agreements was independent of the holding of tax-exempt obligations.[40]

---

[38] Rev. Proc. 70-20 was modified by Rev. Proc. 83-91, 1983-2 C.B. 618, to provide that a deduction will generally not be disallowed in the case of repurchase agreements collateralized by tax-exempt securities (as well as those collaterialized by taxable obligations). This modification was in response to the decision in *New Mexico Bancorporation v. Comm'r,* 74 T.C. 1342 (1980) (discussed below).

[39] Face-amount certificates are certificates under which the issuer agrees to pay to the holder, on a stated maturity date, at least the face amount of the certificate, including some increment over the holder's payments. Present law (sec. 265(2)) provides that interest paid on face-amount certificates by a registered face-amount certificate company shall not be considered as interest incurred or continued to purchase or carry tax-exempt obligations, to the extent that the average amount of tax-exempt obligations held by such institution during the taxable year does not exceed 15 percent of its average total assets. The *Investor Diversified Services* case involved a face-amount certificate company whose tax-exempt holdings exceeded 15 percent of its total assets.

[40] Rev. Proc. 80-55, 1980-2 C.B. 849, would have disallowed a deduction for interest paid by commercial banks on certain time deposits made by a State and secured by pledges of tax-exempt obligations. The revenue procedure concerned banks that participate in a State program that requires the banks to bid for State funds and negotiate the rate of interest, and requires

Continued

20-percent reduction in preference items

Under a provision originally added by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), and modified by the Deficit Reduction Act of 1984, the amount allowable as a deduction with respect to certain financial institution preference items is reduced by 20 percent. (The original TEFRA rule provided for a 15 percent reduction.) Financial institution preference items include interest on indebtedness incurred or continued by financial institutions[41] to purchase or carry tax-exempt obligations acquired after December 31, 1982, to the extent that a deduction would otherwise be allowable for such interest. Unless the taxpayer (under regulations to be prescribed by the Treasury) establishes otherwise, the 20 percent reduction applies to an allocable portion of the taxpayer's aggregate interest deduction, to be determined by multiplying the otherwise allowable deduction by the ratio of the taxpayer's average adjusted basis of tax-exempt obligations during the year in question to the average adjusted basis of the taxpayer's total assets. For example, a bank which invests 25 percent of its assets in tax-exempt obligations is denied a deduction for $5,000 of each $100,000 of interest paid to its depositors during the taxable year (20 percent X $25,000 interest allocable to debt used to acquire or hold tax-exempts). For purposes of this provision, interest specifically includes amounts paid in respect of deposits, investment certificates, or withdrawable or repurchasable shares, whether or not formally designated as interest.

Administration Proposal

The Administration proposal would deny banks, thrift institutions, and other financial institutions a deduction for any interest payments that are allocable to the purchase or carrying of tax-exempt obligations acquired on or after January 1, 1986. The amount of interest allocable to tax-exempt obligations would be determined as it is for purposes of the 20 percent reduction in preference items under present law. Thus, a deduction would be denied for that portion of a bank's otherwise allowable interest deduction that is equivalent to the ratio of (1) the average adjusted basis during the year of tax-exempt obligations held by the bank and acquired on or after January 1, 1986, to (2) the average adjusted basis of all assets held by the bank. For example, if an average of one-third of a bank's assets during the year consisted of tax-exempt obligations acquired in 1986 or later years, the bank would be denied one-third of its otherwise allowable interest deduction. The proposal states that this pro rata presumption would be irrebutable.[42]

---

the State to leave such deposits for a specified period of time. The IRS took the position that direct evidence of a purpose to purchase or carry tax-exempt obligations exists in such transactions under Rev. Proc. 72-18. Rev. Proc. 80-55 was revoked by Rev. Proc. 81-16, 1981-1 C.B. 688. However, Rev. Proc. 81-16 states that the disallowance provision will continue to apply to interest paid on deposits that are incurred outside of the ordinary course of the banking business, or in circumstances demonstrating a direct connection between the borrowing and the tax-exempt obligations.

[41] The provision applies to commercial banks, mutual savings banks, domestic building and loan associations, and cooperative banks.

[42] Administration proposal, p. 244.

Under the Administration proposal, the 20 percent disallowance rule would continue to apply with respect to tax-exempt obligations acquired between January 1, 1983, and December 31, 1985. Thus, a financial institution would reduce its otherwise allowable interest deduction by the sum of (1) 100 percent of interest allocable to tax-exempt obligations acquired in 1986 or later years, and (2) 20 percent of interest allocable to tax-exempt obligations acquired in calendar years 1983 through 1985, each determined under the formula above. For example, if 25 percent of a bank's assets consisted of tax-exempt obligations acquired in 1986 or later years, and an additional 25 percent consisted of tax-exempt obligations acquired in 1983, 1984, or 1985, the bank would be denied 30 percent of its otherwise allowable interest deduction (i.e., 25 percent attributable to obligations acquired in or after 1986, and 5 percent (.20 x 25 percent) attributable to obligations acquired in 1983-85).

Analysis

The allowance of interest deductions to financial institutions which acquire or hold tax-exempt obligations raises a number of legal and policy issues. These include (1) administrative problems, including the tracing of borrowed funds and, in the absence of tracing, the allocation of funds among different purposes of the taxpayer; (2) a concern for tax equity, since financial institutions are generally allowed to deduct interest on debt used to finance the acquisition or holding of tax-exempt obligations, while most other taxpayers are prohibited from doing so; and (3) the probable effect of any modification of the existing rule on the market for tax-exempt State and municipal bonds.

Administrative problems

The disallowance provision generally

The basic policy of the disallowance provision is to prevent a taxpayer from receiving tax-exempt income and paying tax-deductible interest on the same or equivalent funds. Thus, in a simple case, a taxpayer who borrows $10,000, which he then immediately invests in tax-exempt obligations, is denied a deduction for interest paid to the lender on the $10,000. This prevents a result under which the taxpayer, by receiving the benefits of both tax-exempt income and the interest deduction, could offset taxes on other income (and thereby reduce Federal tax revenues) merely by serving as a pass-through for the funds.

As the taxpayer's finances become more complex, the administration of the disallowance provision becomes progressively more complicated. Because money is fungible—that is, one $10,000 is the same as any other $10,000—it is difficult to determine whether a taxpayer is financing the acquisition or holding of particular tax-exempt obligations with the proceeds of any particular indebtedness. It may be even more difficult to determine whether the taxpayer has the actual purpose of doing so. This is particularly true in the case of a corporation (or a wealthy individual) which constantly incurs debt for a variety of purposes and which also, in separate transactions, acquires and holds tax-exempt obligations.

Application to banks

The fungibility problem is particularly acute with respect to banks,[43] whose major business consists of the lending and borrowing of interchangeable sums of money, including (to varying degrees) the acquisition and holding of tax-exempt obligations. Even the purposes test, when applied to banks, may result in conflicting conclusions. A bank may argue that, in accepting deposits, it is simply carrying on its general business as a bank—in a sense, that it has an independent business purpose for incurring debt to its depositors. According to this view, the bank should be allowed an interest deduction under the general principles applicable to all taxpayers. Alternatively, the bank may argue that the acceptance of deposits does not constitute borrowing, at all.[44] It may also be argued, however, that an equally established purpose of a bank's general business (as demonstrated by bank practice) is the acquisition and holding of tax-exempt obligations. Under this interpretation, an allocable portion of deposits accepted in the general course of business should be considered to have been accepted for the purpose of investing in tax-exempt obligations, and the deduction for that portion should be disallowed.

The Administration proposal would deny financial institutions a deduction for an allocable portion of interest paid on deposits and other indebtedness, equivalent to the portion of the institution's assets which is invested in tax-exempt obligations. This approach avoids tracing problems and is comparable to the treatment accorded under present law to dealers in tax-exempt obligations (other than banks) who borrow money for the general purpose of conducting a general brokerage business, including the acquisition and holding of tax-exempt and non-tax-exempt obligations. However, in the case of dealers, a tracing rule is applied where interest is directly related to the acquisition or holding of tax-exempt obligations (resulting in disallowance), or to certain other purposes, e.g., acquiring or improving physical facilities (resulting in allowance of related interest deductions); proportional allocation applies only to interest which cannot be differentiated between different purposes.[45] Thus, the law takes into account the particular situations of different dealers. By applying a proportionate disallowance to all interest deductions by financial institutions, the Administration proposal would deny this flexibility. However, in the absence of a proportionality rule, the problems of assessing a bank's "purpose" in accepting deposits would remain as under present law.

Tax equity

Aside from revenue considerations, a major argument against present law is that it prescribes differing treatment for financial

---

[43] As used in this analysis, the term "banks" refers to all taxable financial institutions. Of tax-exempt obligations held by financial institutions, the great majority are held by commercial banks.

[44] Banks may argue that deposits are distinguished from most other forms of debt, since they are (1) for an unspecified period, and (2) terminable at the will of the depositor, but not of the bank. *See, Investors Diversified Services, Inc. f. United States*, 573 F.2d 843, 853 (Ct. Cl. 1978.) This argument is obviously less applicable for time deposits.

[45] *See* Rev. Proc. 72-18, 1972-1 C.B. 740; *Leslie v. Comm'r*, 413 F.2d 636 (2d Cir. 1969), *cert. den.* 396 U.S. 1007 (1970).

institutions and other taxpayers. By using deposited funds to purchase or carry tax-exempt obligations, banks are able to enjoy the benefits of receiving tax-exempt investment income and paying tax-deductible interest on the same or equivalent funds—precisely the double benefit which is denied to other taxpayers. The volume of tax-exempt obligations held by banks (currently about one-third of all such obligations) indicates that banks have made extensive use of deposited funds to acquire and hold tax-exempts. This situation has contributed to the relatively low effective tax rates paid by banks since, by deducting the interest on debt used to purchase tax-exempt obligations, a bank can "zero out" its taxable income by investing a relatively small percentage of its assets in tax-exempt obligations. For example, even allowing for the 20 percent "cutback" on tax preferences, a bank that earns an average return of 10 percent on its taxable assets and pays an average of 8 percent on deposits would pay no tax if it invested approximately 24 percent of its assets in tax-exempt obligations. The disallowance of interest deductions also may lead to economic inefficiency, since a bank may have an incentive to hold tax-exempt obligations even when they pay substantially less interest than the bank pays to its depositors. Banks have maintained that they merely are passing through the benefits of tax exemption in the form of lower interest rates and that these reduced interest rates are a form of implicit tax on the banks.

A particular problem under present law is the use of tax-exempt obligations as collateral for deposits or other short-term bank borrowing. By using tax-exempt obligations as collateral, a bank receives tax benefits when it is really the depositor (who may be tax-exempt or have a low marginal tax rate) who is lending to the issuing government. State and municipal deposits in particular are frequently collateralized with tax-exempt obligations, sometimes of the same State or municipality;[46] in these cases, the Federal government subsidizes a transaction in which there may be no net borrowing by the State or local government. Rev. Proc. 80-55, 1980-2 C.B. 849, would have disallowed a deduction for interest paid by commercial banks on certain time deposits made by a State and secured by pledges of tax-exempt obligations; however, this revenue procedure was subsequently withdrawn.[47]

An essential difference between the present law treatment of financial institutions and other taxpayers is that opposite presumptions are applied to each group. Thus, under Rev. Proc. 72-18, a rebuttable presumption exists that an individual has the purpose of carrying tax-exempt obligations when the relevant indebtedness is not directly connected with personal expenditures and is not incurred or continued in connection with the active conduct of a trade or business. Corporations face a similar negative presumption when they borrow in excess of reasonable business needs. In contrast, banks are subject to disallowance of interest only when "*unusual facts and circumstances outside of the normal course of*

[46] State or local law frequently requires that State and municipal deposits be collateralized with obligations of specified governmental bodies. These may include taxable or tax-exempt obligations.

[47] Rev. Proc. 80-55 is discussed further below.

business . . . demonstrate a direct connection between the borrowing and the investment in tax-exempt securities." Rev. Proc. 70-20, 1970-2 C.B. 499, 500 (emphasis supplied). The law thus creates a presumption that debts incurred in the normal course of the banking business (including all or nearly all deposits) are *exempt* from the disallowance provision. This contrasts in particular with the treatment of dealers in tax-exempt securities, who are presumed to have used a ratable portion of untraceable funds for the purpose of acquiring or holding tax-exempts.[48]

The Administration proposal would eliminate the current advantage enjoyed by financial institutions, by denying a deduction for that portion of interest payments which is equivalent to a bank's tax-exempt holdings. Supporters argue that this would result in equal treatment and a "level playing field" between banks and other taxpayers. Banks, however, have argued that the rule would discriminate unfairly against them, since they would be subject to an automatic (albeit proportional) disallowance, while other taxpayers would be dealt with on a facts and circumstances basis. One possible response to this would be to apply a proportional disallowance to all taxpayers, or at least to all corporations, including dealers in tax-exempt securities. A flat proportional rule, however, would be difficult to administer for many taxpayers, and could lead to harsh results in certain cases, e.g., denial of a portion of individual (or corporate) mortgage deductions because the taxpayer held some tax-exempt obligations. Another approach would be to disallow all deductions on interest which is traceable to tax-exempt obligations, allow deductions on interest traceable to other purposes (e.g., mortgage interest), and apply a proportional rule to remaining (untraced) interest—a "three basket" approach similar to that currently applied to broker-dealers. This approach, however, is the most complex of all, and leaves the question of whether any of a bank's (or other taxpayer's) funds can ever accurately be traced.

State and municipal finance

Tax-exempt bonds are a major source of financing for State and municipal governments. Financial institutions (primarily commercial banks) presently hold about one-third of outstanding tax-exempt bonds, although this percentage has declined somewhat in recent years.

Legislative history indicates a Congressional concern that, if banks were denied an interest deduction in proportion to their tax-exempt holdings, the banks would eliminate or substantially reduce their investments in tax-exempt bonds. The Senate Finance Committee in 1934, rejecting a proposed change in the rule, expressed the opinion "that the change made by the House bill will seriously interfere with the marketing of government securities, which are bought for the most part by banks and financial institutions, and also presents grave administrative difficulties."[49]

---

[48] According to Rev. Proc. 72-18, where indebtedness is incurred for the general purposes of conducting a brokerage business, "it is reasonable to infer that the borrowed funds were used for all the activities of the business which include the purchase of tax-exempt obligations." Accordingly, section 265(2) of the Code is applicable in such circumstances. Rev. Proc. 72-18, 1972-1 C.B. 740, 742.

[49] S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934).

In 1980, when the Internal Revenue Service issued Rev. Proc. 80-55, *supra*, banks and various State and local governments protested that the disallowance of deductions on the deposits in question would depress the market for tax-exempt bonds, making it more difficult for States and municipalities to raise needed funds. (It was also argued that the revenue procedure was inconsistent with previous interpretations of the disallowance provision.) The IRS revoked Rev. Proc. 80-55 in April 1981.

The denial of interest deductions is one of several aspects of the Administration proposal affecting the tax-exempt bond market. Other proposals include the elimination of nongovernmental tax-exempt bonds and the application of tightened arbitrage and advance refunding restrictions to all tax-exempt obligations.[50] The combined effect of these proposals would be to reduce the volume as well as the attractiveness (at least to financial institutions) of tax-exempt bonds generally. However, certain aspects of the proposal could potentially offset one another. For example, while disallowance of bank interest deductions (coupled with reduced marginal rates) would tend to reduce demand for tax-exempt bonds (especially short-term obligations) and thereby increase yields, the elimination of nongovernmental bonds would arguably increase demand for remaining "public purpose" bonds, and thereby have an opposite effect.[51] Stated differently, there would be fewer taxpayers wanting to hold tax-exempt bonds, but there would also be fewer tax-exempt bonds to hold. How one views this situation depends on one's view of the costs and benefits associated with tax-exempt bonds, generally.[52]

One likely result of the Administration proposal is at least some shift in tax-exempt bond ownership toward individuals, and away from financial institutions. Banks have argued that the effective date of the provision should be adjusted to exempt obligations originally issued (as opposed to obligation acquired) before 1986, which they suggest would minimize the incentive to sell existing obligations and the potential effect of such sales on the tax-exempt market.

---

[50] *See*, Joint Committee on Taxation, *Tax Reform Proposals: Tax Treatment of State and Local Government Bonds* (JCS-23-85), July 16, 1985, pp. 43–46.

[51] *See*, Administration Proposal, p. 245.

[52] These issues are discussed further in the pamphlet regarding tax-exempt bonds, referenced in note 50, *supra*.

C. Special Rules for Reorganizations of Financially Troubled Thrift Institutions

Present Law and Background

In 1981, Congress added several provisions to the tax Code that were designed to facilitate acquisitions of financially troubled thrift institutions by financially stronger institutions.[53] These provisions were enacted at a time when many thrift institutions were experiencing financial difficulties as a result of having extended long-term mortgage loans to borrowers, while at the same time being forced to pay high interest rates on short-term deposits. In some cases, the institutions were forced to merge into other institutions to resolve their financial problems. In connection with these mergers, the Federal Savings and Loan Insurance Corporation (FSLIC) frequently would contribute money to the acquiring organization (or the financially troubled institution) as an inducement to the acquisition.

Continuity of interest requirement

It had been unclear under prior law whether a merger of one thrift institution into another could satisfy the judicially-created "continuity of interest" requirement. The continuity of interest doctrine generally requires that the shareholders of an acquired corporation maintain a meaningful ownership interest in the acquiring corporation in order for the transaction to qualify as a tax-free "reorganization" within the meaning of section 368(a).[54]

Because of the unusual nature of despositors' interests in thrift institutions, there was considerable uncertainty under what circumstances the depositors of an acquired thrift would be deemed to have a substantial equity interest in the acquiring institution.[55] If the transaction failed to qualify as a reorganization, the acquiring corporation would take a cost basis in the acquired thrift's assets, rather than assuming the thrift's basis. In many cases, a carryover basis was desirable because the thrift's basis in its assets exceeded their fair market value.

---

[53] Secs. 235-238 of Pub. L. 98-34, 97th Cong., 1st Sess. (1981), referred to as the Economic Recovery Tax Act of 1981 (ERTA).

[54] *See Penellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462, 468-470, Treas. Reg. sec. 1.368-1(b), 1.368-2(a).

[55] In Rev. Rul. 69-3, 1969-1 C.B. 103, the Service ruled that a merger of a mutual savings and loan association into another mutual savings and loan association qualified as a tax-free reorganization. A recent decision by the Supreme Court, however, held that a merger of a stock savings and loan into a mutual savings and loan failed to qualify as a tax-free reorganization. The Court held that continuity of interest did not exist because the depositors in the acquired institution (whose savings accounts were converted into accounts in the acquiring institution) received essentially cash plus an insubstantial equity interest. *Paulsen* v. *Commissioner*, 105 S. Ct. 627 (1985). The legislative history of the 1981 amendments made it clear that the provision covered all possible combinations of stock and mutual thrift institutions, including stock acquiring mutual, stock acquiring stock, mutual acquiring mutual, and mutual acquiring stock.

In addition, if the transaction qualified as a tax-free reorganization, the acquiring institution would generally succeed to the acquired thrift's net operating loss carryovers, subject to certain limitations in section 382.[56]

Under the 1981 amendments, the continuity of interest requirement need not be satisfied in the case of a merger involving thrift institutions, provided certain conditions are met. First, the acquired institution must be one to which section 593 applies, namely, a savings and loan association, a cooperative bank, or a mutual bank. Second, the FSLIC or the Federal Home Loan Bank Board (FHLBB) (or, if neither has jurisdiction, an equivalent State authority) must certify that the thrift is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future. Third, substantially all of the liabilities of the transferor institution (including deposits) must become liabilities of the transferee. If these conditions are satisfied, the acquired institution need not receive or distribute stock or securities of the acquiring corporation for the transaction to qualify as a tax-free reorganization (sec. 368(a)(3)(D)).

In addition, in applying the loss limitation provisions of section 382, deposits in the acquired corporation that become deposits in the transferee corporation are treated as stock of both corporations.

FSLIC contributions to savings and loan associations

Although contributions to capital by nonshareholders are excluded from the income of the recipient corporation (sec. 118), the basis of property normally must be reduced by such contributions (sec. 362(c)). The 1981 Act, however, provided that certain financially troubled thrift institutions need not reduce their basis for money or property contributed by the FSLIC under its financial assistance program (sec. 597(b)).

Administration Proposal

The Administration proposal would repeal the special rules relating to acquisitions of financially troubled thrift institutions and the exclusion from income of FSLIC payments to such thrifts. The repeal of the reorganization rules would take effect on a delayed basis, however. The repeal be effective for acquisitions or mergers occurring on or after January 1, 1991. The exclusion for certain FSLIC payments would be repealed for taxable years beginning on or after the same date, although an exception would be provided for payments made pursuant to an agreement entered into before that date.

Analysis

In support of its proposal to repeal the special reorganization rules applicable to financially troubled thrifts, the Administration

---

[56] Under section 382, the ability of an acquiring corporation to succeed to the net operating loss carryovers of a corporation acquired in a reorganization is limited to the extent the owners of the acquired corporation fail to acquire stock in the acquiring corporation representing at least 20 percent of the value of the latter's stock (sec. 382(b)).

argues that these rules simply provide an indirect Federal subsidy to thrift institutions. To the extent acquiring institutions are permitted to realize tax benefits that are otherwise unavailable (for example, because continuity of interest is not maintained in the transaction) in exchange for assuming the obligations of a failing thrift, the Federal Government is in effect making payments to the thrift or its successor. The burden of these payments properly belongs on the FSLIC's member institutions, who presumably would pay higher insurance premiums absent the tax subsidy. If subsidies to the thrift industry are necessary, the Administration argues, they should be done directly through the appropriations process.

Opponents of the proposal, while conceding that these special rules will be unnecessary if thrift institutions have fully adjusted to a deregulated environment, argue that a reexamination of the need for the rules in five years is preferable to a provision requiring a definite "sunset" in 1991. In the financial markets are unstable at that time and interest rates are high, some special incentives for mergers of financially troubled institutions with stronger institutions may be necessary. In addition, some argue that in the meantime, the rules should be amended to clarify that financial assistance payments to thrift institutions by the Federal Deposit Insurance Corporation (in addition to payments by the FSLIC) qualify for the exclusion under section 597.

The special treatment accorded to financially troubled thrift institutions undergoing a merger may serve as a significant incentive to another institution to acquire an ailing thrift. An acquisition by an ongoing, healthy institution may avoid the disruptive and costly process whereby the FSLIC is forced to take control of the thrift and satisfy its obligations to depositors. On the other hand, in order to avoid this result, the Federal Government must concede what may amount to substantial tax benefits to the acquiring institution in the form of higher basis in assets and net operating loss carryovers. The relevant inquiry is which approach is the more efficient means of accomplishing the desired objectives.

One could argue that it is inappropriate as a matter of tax policy to accord savings and loans and their depositors more favorable treatment than other business enterprises in a similar situation. If there are other reasons for granting Government subsidies to thrift institutions, it may be more appropriate to provide these subsidies on a case-by-case, direct appropriation basis, rather than through a wholesale exemption from the generally applicable reorganization rules. A direct subsidy approach might allow targeting of the relief to those situations where it would be most cost-effective and beneficial, and would make it easier to verify the true cost of the such subsidies.

D. Credit Unions

Present Law and Background

Credit unions are exempt from Federal income tax under present law. This exemption applies regardless of whether, or to what extent, income of the credit union is distributed as dividends. Both State and Federally chartered credit unions are exempt from tax.

State chartered credit unions have always been exempt from Federal income tax. Until 1951, the tax exemption for these credit unions was subsumed under the tax exemption for savings and loan associations. When the exemption for savings and loan associations was terminated as part of the Revenue Act of 1951, the exemption for credit unions was continued in a separate Code provision (sec. 501(c)(14)). This provision grants an exemption for credit unions without capital stock and which are organized and operated for mutual purposes and without profit.

Federally chartered credit unions were originally authorized by the Federal Credit Union Act of 1934. The tax exemption for these credit unions is specified by section 122 of the Federal Credit Union Act (12 U.S.C. sec. 1768). Under this provision, Federal credit unions are also exempt from State and local taxation, except for taxes on real and tangible personal property.

Administration Proposal

The Administration proposal would repeal the Federal income tax exemption for credit unions having assets of $5 million or more. These credit unions would be subject to the same tax rules as would apply to thrift institutions (e.g., savings and loan associations and mutual savings banks).[57] Under this proposal, retained earnings of a taxable credit union (i.e., earnings not distributed as dividends to members) would be subject to tax at the credit union level, while dividends would be taxable to the individual members. The proposal would be effective for taxable years beginning on or after January 1, 1986.

Other Proposals

1984 Treasury Report

The 1984 Treasury report recommended repealing the tax exemption for all credit unions.

---

[57] For proposed amendments which would limit thrift institutions and credit unions to the specific charge-off method of computing bad debt deductions, see Part II.A.2, above.

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would repeal the tax exemption for all credit unions, effective for taxable years beginning on or after January 1, 1987.

Analysis

Credit unions were orginally exempted from tax, together with savings and loan associations, because both credit unions and savings and loan associations operated on a "mutual" basis (that is, on behalf of and for the benefit of their members), and not as separate profit-seeking entities. Because of this structure, it was thought that the income of these entities should be taxed only when distributed to the members. In addition, credit unions were generally small, unsophisticated financial institutions, operated by volunteers.

In 1984, Federal credit unions[58] earned approximately $5.1 billion in net income, of which approximately $4.4 billion was paid out in dividends and interest to member-depositors. Undistributed net income of Federal credit unions (after subtracting dividend and interest payments and reserve transfers) increased from $34 million in 1975 to $476 million in 1984.[59] While many credit unions remain small, there are today also many relatively large credit unions, and credit unions offer an array of services that are not always distinguishable from those offered by banks and taxable thrift institutions. Other mutual financial institutions which compete with credit unions, including mutual savings banks, are subject to tax on income not paid out as dividends to their member-depositors. These and other competing institutions may be at a disadvantage with respect to credit unions, which can accumulate tax-free income (and interest on that income). Some argue, therefore, that the credit union exemption should be reconsidered and credit unions be treated the same as taxable thrift institutions.

Credit unions representatives argue that credit unions are unlike other financial institutions because they continue to be more closely controlled by, and responsive to, their members. For example, the law requires that most directors of a Federal credit union receive no compensation, and forbids proxy voting in credit union elections. While no longer subject to interest rate limitations, Federal credit unions may lend only to credit union members[60] (or other credit unions) and only for consumer (i.e., nonbusiness) purposes. These requirements, it is argued, ensure that credit unions will act in the direct interest of their members and distinguish them from other, profit-seeking entities. It is further argued that credit unions make loans available to small depositors who would not otherwise qualify for such credit.

---

[58] As of 1984, there were 10,547 active Federally-chartered credit unions and approximately 7,800 state-chartered credit unions. Of the state credit unions, 4,657 were Federally insured. See National Credit Union Administration, *NCUA 1984 Annual Report*, pp. 35, 39; Credit Union National Association (CUNA), *1984 Credit Union Report*.

[59] *NCUA 1984 Annual Report*, pp. 34, 36-37.

[60] Credit union membership must generally be based on some "common bond" between the members, e.g., a common employer or residence in a designated geographic area. Membership may qualify an individual for loans substantially in excess of the amount contributed to (i.e., deposited with) the credit union.

The Administration proposal would retain the tax exemption for credit unions having less than $5 million of gross assets. The proposal states that this would result in taxation of approximately 80 percent of retained earnings of credit unions, while leaving more than four-fifths of all credit unions (that is, the smaller credit unions) untaxed.[61] (Because membership, as well as assets, is concentrated in larger credit unions, the repeal would affect a relatively high proportion of credit union members.) The proposal further indicates that the $5 million threshold would avoid administrative difficulties for smaller credit unions. However, credit union representatives have suggested that taxing the larger credit unions would harm smaller institutions as well, by reducing the capitalization level of the credit union movement and initiating a trend toward more "profit-driven" (and possibly more risky) investment.

If Congress wishes to repeal the general credit union tax exemption, while retaining some protection for smaller credit unions, it may wish to consider exempting a specified amount of income of any credit union from tax, and imposing tax only on the excess over this amount. While somewhat more complex adminstratively, this would avoid the "cliff" which occurs in the Administration proposal (i.e., credit unions below $5 million in assets remain exempt from tax, while those just above $5 million must pay tax on their full retained earnings). Congress may also wish to consider "phasing in" the taxation of some or all credit unions over a multi-year period.

[61] This proposal is found on pp. 247-248 of the Administration Proposal.